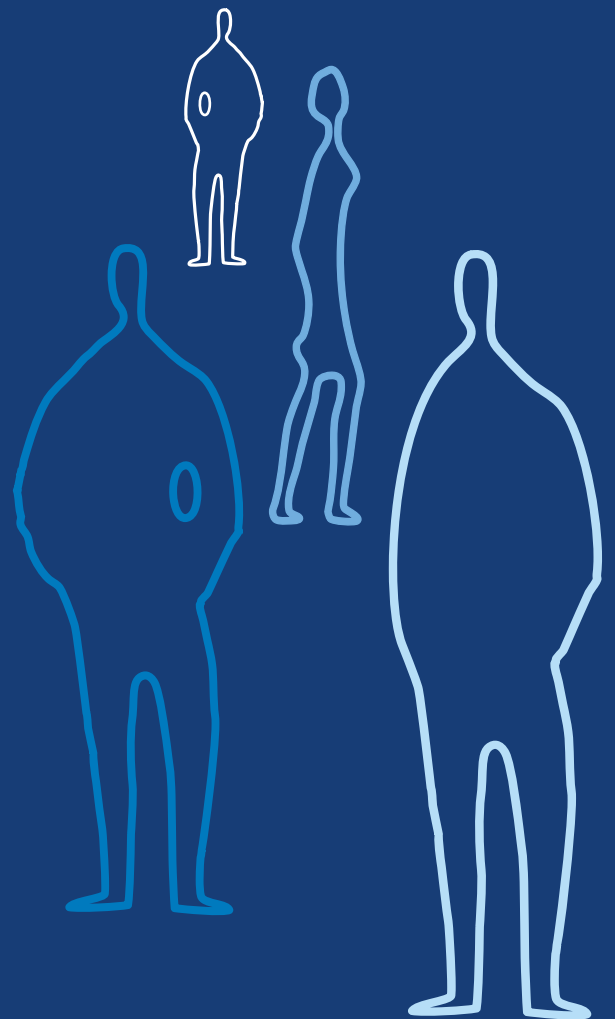


# An Introduction to Internal Auditing in Banking



**Barclay Simpson**  
Recruitment Consultants



# Contents

## 1.0 Introduction

- 1.1 Purpose
- 1.2 General Control Considerations
- 1.3 Types of Financial Institution
- 1.4 Organisation Structure
- 1.5 Terminology

## 2.0 Main Businesses and Functions

- 2.1 Front Office
  - 2.1.1 Sales and Trading
  - 2.1.2 Capital Markets
  - 2.1.3 Corporate and Investment Banking
  - 2.1.4 Trade Finance
  - 2.1.5 Research
  - 2.1.6 Private Equity
  - 2.1.7 Fund Management
- 2.2 Middle Office
  - 2.2.1 Product Control
  - 2.2.2 Risk Reporting
- 2.3 Back Office
  - 2.3.1 Operations
  - 2.3.2 Financial Control
  - 2.3.3 Credit
  - 2.3.4 Legal
  - 2.3.5 Compliance
  - 2.3.6 Information Technology
  - 2.3.7 Taxation
  - 2.3.8 New Business

## 3.0 Generic Risk Types

- 3.1 Market Risks
- 3.2 Credit Risks
- 3.3 Operational Risks
- 3.4 Legal and Regulatory Risks
- 3.5 Continuity Planning Risks
- 3.6 Image/Reputation Risks
- 3.7 Fraud Risks

## 4.0 Critical Control Functions

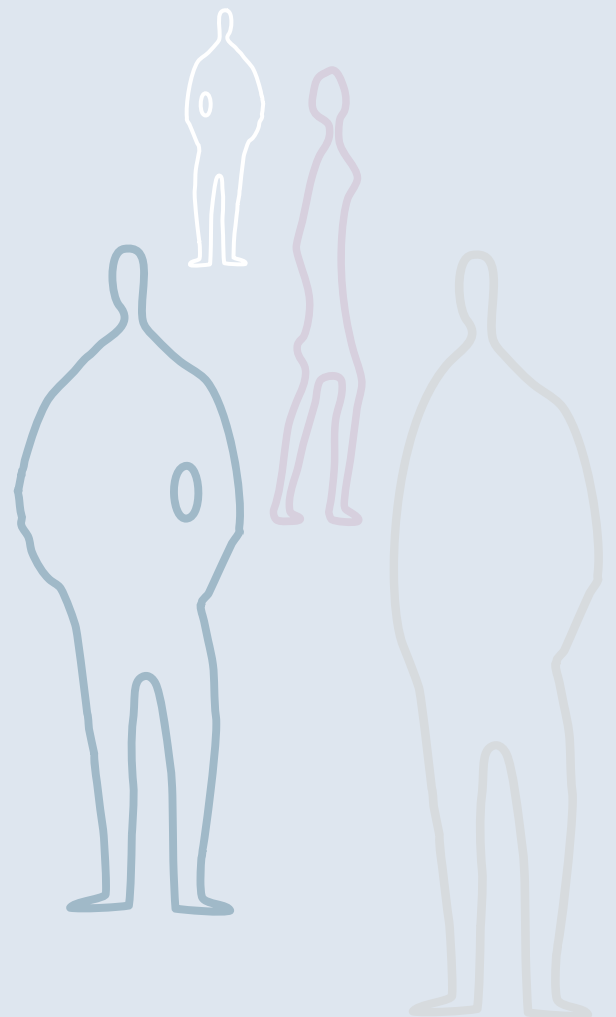
## 5.0 Role and Responsibilities of Internal Audit

- 5.1 What does Internal Audit do?
- 5.2 What does Internal Audit not do?
- 5.3 How should Internal Audit be organised?
- 5.4 What is the Role of the Audit Committee?
- 5.5 What skills does the Internal Auditor need?
- 5.6 How does Internal Audit liaise with External Audit?

## 6.0 Regulatory Environment

- 6.1 Overview
- 6.2 Money Laundering
- 6.3 Capital Adequacy
- 6.4 Insider Dealing
- 6.5 Chinese Walls

## Glossary



# 1. Introduction

## 1.1 Purpose

The objective of these notes is to give an overview of the major business activities that are generally described as banking and to provide a perspective from an internal audit viewpoint. This will include a summary of the main businesses and functions, the key areas of risk and the related control functions. The notes have been written to assist candidates with limited knowledge of banking who are planning to attend an interview with a financial institution. The notes are not intended as a comprehensive manual of risks and controls, but rather a general guide to critical areas which may be raised at an interview.

The scope of the notes applies to investment banking and fund management organisations and does not include the retail banking sector, building societies or private banking.

## 1.2 General Control Considerations

In covering the specific business areas and risks in the ensuing sections, it is important to emphasise also that fundamental management practices for effective corporate governance, common to all commercial organisations, will inevitably also apply within banks. These will include sound management hierarchies, effective management supervision of key functions, clearly-designated roles and responsibilities, independence of check in key areas and maintenance of appropriate quality and numbers of staff at all levels. There should also be properly documented policies and procedures for all activities of the institution and formally documented levels of signing authority for all transactions, commitments and payments. Internal audit must be cognisant of all of these issues, as well as the more technical business risks, in completing its coverage.

## 1.3 Types of Financial Institution

Over the last 15 to 20 years, the deregulation and globalisation of financial markets, combined with the merging of organisations from different areas of the market, have resulted in the creation of ever-larger international financial institutions with presence in many different markets. Prior to Big Bang, in 1987, there were clear distinctions between commercial banks, securities houses, merchant banks, fund managers and brokers. As these different entities merged and amalgamated, the new breed of investment banks encompassing all of these businesses was born.

Nevertheless, although there are a number of truly global investment banks, there remain many institutions which specialise in one or more specific types of banking or fund management business. It is also worth noting that, where a global investment banking group undertakes all of these business types, separate entities and management structures will normally exist within the group for each type of business. As such, it will not be difficult for the new employee to learn the characteristics and idiosyncracies of each of these types of business in a systematic way.

## 1.4 Organisation Structure

Before discussing the business types in more detail, it is worth explaining briefly how banks typically organise their functions. Broadly, any financial institution can usually be separated into "Front Office", "Middle Office" and "Back Office" departments and functions. Put simply, these categories can be summarised as follows:

**Front Office**

These functions relate to the “business-end” of the organisation and the generation of revenue streams. They are concerned with marketing and sourcing new business; arranging, structuring, pricing and committing new transactions; trading and risk management; managing client relationships and providing client advisory services. This will therefore include traders, risk managers, marketers, bankers, fund managers and research analysts. In addition, technical managers (sometimes known as “quants”) who develop financial models for pricing complex transactions such as exotic derivatives will also be part of the front office.

Reporting lines of all staff will typically be to business heads and then to executive management.

**Middle Office**

These functions serve as a link between the front and back offices. The definition of middle office functions tends to vary somewhat from bank to bank, but will normally include administration and support for the front office businesses. However, the term “middle office” has been broadened in recent years to incorporate departments whose key control functions necessitate close ongoing liaison with front office. These include Product Control and Risk Reporting which perform important control checks on the accuracy of profits and loss and risk numbers generated by front office. Given the criticality of an independent check on the activities of the front office, the internal auditor must be mindful of the importance of independent reporting lines to back office heads.

**Back Office**

These functions include the Operations, Financial Accounting, Credit, Information Technology, Legal and Compliance departments. Their roles ensure that transactions are properly processed, documented and accounted for and are within properly approved limits. They also monitor the legal and regulatory implications of the firm’s businesses, and ensure the maintenance of the IT and support services infrastructure. Section 2 contains a more detailed breakdown of back office functions

Reporting lines of staff will be to department heads and then, typically, to a Chief Operating Officer, reporting to the Executive.

**1.5 Terminology**

Like all specialist business sectors, banking contains its own lexicon of technical definitions and terminology. In producing these notes we have endeavoured to minimise the usage of technical jargon and acronyms except where explaining specific products or risks. A Glossary is included at the back of this guide. If confronted with technical language at an interview the interviewee should not be afraid to request clarification from the interviewer.

Barclay Simpson would like to acknowledge the assistance of Richard Marsh in the completion of this guide.

## 2.0 Main Businesses and Functions

### 2.1 FRONT OFFICE

In providing the following summary of business areas, it is important to recognise that there is no single blueprint for how banks organise their business areas and different institutions will set up different structures according to their own perceived strengths and business strategies.

#### 2.1.1 Sales and Trading

The trading floors of the investment banks can broadly be separated into the sales (marketing) staff, who have responsibility for marketing the bank's products to new customers and sourcing new business, and the traders (or risk managers) who manage the bank's risk positions, provide prices for new transactions, and transact in the market place. Traders and marketers operate within their own areas of specialisation. For example, marketers may be split according to regional responsibilities (UK; US; Emerging markets etc), whilst traders will be responsible for managing a specific currency, interest rate or product-type. Trades are executed either for the account of the bank (ie its own positions) or for the accounts of customers.

Investment banks which trade in debt and equity markets may operate both in the primary markets, where new issues are brought to market, and the secondary markets, where existing issues are traded. Where a primary market issue is being lead managed or underwritten by the bank, there will be close liaison between trading and investment banking departments as to the pricing, timing and mechanics of the issue into the market.

For the purposes of this guide, we have separated Sales and Trading into Fixed Income, Equity, and Other markets. It is important to note that, while referred to separately, there is cross-market linkage in all of these areas and traders do not operate in isolation. Indeed, in the more complex structured products, expertise will be required from several trading areas in pricing transactions. Capital Markets business is shown separately below since it can involve close linkage between the sales and trading departments and the investment banking

#### Fixed Income

The term Fixed Income is slightly misleading since this covers all types of currency, bond and interest rate businesses. These include the markets noted below

#### Foreign Exchange [FX]

Refers to the trading of foreign currencies either spot or forward against a base currency. Trading will be either for the bank's own account or to provide foreign currency to a customer. This may also include derivative transactions such as currency options .

#### Money Markets

Money market activities include placing or receiving of cash deposits, trading in certificates of deposit [CD's], short term debt instruments, such as commercial paper, floating rate notes and repurchase agreements (repos). Traders will operate either in their own domestic markets or in the international money markets. They

will also trade in derivative instruments such as futures, interest rate options, swaps and forward rate agreements [FRA's] either as a means of hedging the risks from their own portfolios, or as a service to customers.

### **Treasury**

Typically, banks will maintain a group of traders whose responsibility is to ensure the effective funding of the firm's balance sheet. This will necessitate transacting in foreign exchange and cash markets to maintain

Liquidity and ensures that the bank funds its assets at the most cost-effective rates and can meet its liabilities as they fall due.

### **Equities**

Investment banks will buy and sell company shares either acting as a principal to the transaction or, where the firm is registered with the relevant Stock Exchange, as a broker. Transactions may be for the bank's own account or, where acting as broker, for the account of a customer. In addition, derivative markets have grown on the back of the main global equity markets and some banks may trade in equity futures, warrants, options and structured products.

In addition to acting as broker, some institutions will also provide a prime broker service in which they act as main broker for all transactions executed by the client. Transactions executed through other brokers will then be routed via the prime broker who will perform all settlement and delivery functions. This service is attractive to hedge funds, for example, who wish to keep their processing simple and cost-effective.

Equity borrowing and lending is a separate market where banks can effectively borrow funds using their shares as security, or alternatively lend funds based on equities put up as collateral.

### **Other Markets**

Banks may also trade in more specialised areas such as commodities (e.g. gold, oil) and the rapidly expanding market of credit derivatives. Commodities transactions will not usually involve the physical transfer of the commodity itself, although some banks do physically settle precious metal trades. Credit derivatives have grown as the sophistication of securitisation and derivatives products have developed. They are seen as a means of enabling banks to diversify their credit risks by trading part of their risks with other banks. Inter alia, this may be attractive for purposes of managing their capital adequacy (see section 6.0)

Given their esoteric nature, it is unlikely that an interviewee will be asked any detailed questions about these markets and it suffices for the moment to understand that the businesses exist and, in practice, adopt many of the same principles as the more widely-traded financial instruments, albeit in different underlying markets.

## 2.1.2 Capital Markets

Business activities in the international debt capital markets include government bonds (e.g. US Treasuries, UK Gilts), and assisting and advising companies in issuing new securities (e.g. Eurobonds). Equity capital markets involve the management or participation in new share issues, including privatisations and initial public offerings, and convertibles. In some cases banks will underwrite the issues, in exchange for commissions, to effectively guarantee the success of the issue. Traders will also participate in the secondary market.

Institutions that quote buy and sell prices in these issues in the market are known as market makers. The capital market activities of investment banks frequently involve front office managers from both Sales and Trading and the Investment Banking departments, depending on the specific type of business (see below).

## 2.1.3 Corporate and Investment Banking

These business areas cover a wide variety of transaction and service types. The following examples are by no means exhaustive but will serve as illustrations:

### Commercial Lending

This broadly covers the traditional banking business of providing loans to companies or individuals. These loans may be made for simple working capital requirements, or be made for purposes of financing business expansion or specific projects. Banks will typically operate in specific industries (eg petro-chemicals; aircraft financing; property development) and loans will be either secured against an asset of the company (eg a property), guaranteed or unsecured. Loans for large amounts or high risk projects may be syndicated to other banks with the lead bank acting as manager.

### Investment Banking and Corporate Finance

Bankers will also advise client companies about financing their expansion plans and assist in the floating of companies in the market. This will include venture capital activities and may similarly incorporate practical assistance to companies with financial problems in terms of refinancing their borrowings or in corporate restructuring. These activities include bringing new debt and equity issues to market for companies, including advice as to structure, type of security, pricing and timing. This may involve a repackaging of existing assets, or future income streams, in new securities, a process known as securitisation. The bank may guarantee the sale of the securities by underwriting. The bankers will receive fees for these Primary Market services, increasing according to the level of risk being taken.

Investment banks will also arrange mergers and acquisitions for their client companies and will be responsible for the negotiation with suitable counterparties, the arranging and documentation of terms and the financing of the transaction.

The business of investment banking necessitates the maintenance, and close internal monitoring, of “Chinese Walls” between the bankers who advise companies on corporate reorganisations, and the traders who can transact in company stocks and shares. More information on this is provided in Section 6.0 on Regulatory Environment

### **2.1.4 Trade Finance**

Historically, banks have been instrumental in the financing and documentation of imports and exports for international trading companies. This includes the issuance of letters of credit on behalf of importers to guarantee payment to exporters, and the confirmation of letters of credit and negotiation of bills of exchange for exporters. These functions are more prevalent in the more traditional commercial banks and require specialised support teams to handle the sometimes complex documentation and international legal requirements.

### **2.1.5 Research**

Investment banks employ analysts who provide detailed research and recommendations to the investment community on stocks, shares, industries and financial markets. These analysts are generally specialists in industry and market sectors and their recommendations can be highly influential in the movement of rates and prices.

### **2.1.6 Private Equity**

Some investment banks have separate Private Equity businesses which set up funds to enable buy-outs of companies which are under-performing and where there is an expectation of future potential enhancement of the company's value. The bank will then participate in the management of the company with the objective of increasing the net asset value in anticipation of the future sale of their investment.

### **2.1.7 Fund Management**

Fund management (also known as "asset management" and "investment management") is undertaken by many institutions on behalf of pension funds, trusts, charities, insurance companies and private investors. The investor enters into an agreement as to how the funds are to be invested with the specialist fund manager, who then transacts in the market. Funds are usually set up to provide a vehicle to invest in a specific region or sector and make returns based on the price movement of the underlying shares or bonds (e.g. unit trusts). Fund management is either discretionary or non-discretionary.

For the fund manager, the mechanics of investing in securities and shares are the same as for any institution that trades equities and bonds (see above). However, the gains or losses from the changes in the prices of the shares are for the account of the investors and are reflected in the changing values of the funds. The fund manager makes his return from commissions earned, or from the difference in the buy and sell values of the fund (known as the "spread").

The need for clear segregation, and effective management, of client assets is clearly of paramount importance in fund management institutions.



## **2.2 MIDDLE OFFICE**

As noted in 1.4, the middle office functions of a bank essentially serve as a link between front and back office. Originally the term was used to refer to administration functions which provide support to the trading and marketing personnel and act as liaison points for back office functions such as Operations. However, the term is now often used to incorporate key control functions such as Product Control and Risk Reporting, whose primary contact is often the front office business heads.

### **2.2.1 Product Control**

Product Control are responsible for independently verifying the valuation and bookings of transactions and ensuring that reported trading profits are prudently and accurately recognised. This will incorporate verification of financial models used in valuations. Whilst the work of this department necessitates close liaison with front office businesses and may include the ongoing provision of Profit and Loss data to front office business managers, the need for independence of this function is self-evident and the reporting lines will be to senior back office management.

### **2.2.2 Risk Reporting**

Risk Reporting (also known as Risk Management) is likewise responsible for independently verifying and compiling the bank's risk numbers. As for Product Control, this work will include regular liaison with, and the provision of daily risk data to, Front Office managers. It is important to note that the prime responsibility for managing and hedging the bank's risks intra-day lies with the Front Office management. However, the criticality of independent control over reported risks means that it is imperative that there is a separate risk reporting function with reporting lines independent of the front office. The extent of the responsibilities of this department will vary from bank to bank, but will normally include the consolidation and reporting of all market risk and operational risk numbers.

The Credit Department is also sometimes viewed as Middle Office though for the sake of this exercise it has been included below as back office.

## 2.3 BACK OFFICE

There are a number of departments which form the standard back office functions of a bank. Whilst the roles of these departments can vary from bank to bank, the following is a brief precis of their main responsibilities:

### 2.3.1 Operations

Responsible for inputting, checking and updating transaction information in the back office systems, maintaining counterparty confirmations and settling all transactions, including all cash payments. They will also reconcile cash ("nostro") and security ("depository") accounts and have responsibility for corporate actions, such as dividend and interest receivables, rights issues etc arising from the bank's holdings. From a control standpoint there are a number of areas where separation of duties is essential e.g.:

- between staff who can input trade information (e.g. settlement instructions) and those who process counterparty confirmations;
- between staff who can authorise payments and those who reconcile the cash accounts.

Operations may also be responsible for transmission of customer statements, though where more complex valuations are required this work may be performed by Product Control.

### 2.3.2 Financial Control

Responsible for the maintenance of General Ledgers, preparation of financial and management accounts, creation of budgets and the submission of statutory reports to regulators. In liaison with Product Control (see above) they will also be responsible for the establishment and implementation of accounting policies and GAAP requirements

### 2.3.3 Credit

Responsible for assessing the credit risk from the bank's exposures to its customers (counterparties). This includes the financial analysis of new and existing counterparties, approval of new customer limits and facilities and monitoring of outstanding exposures against limits. This will also include analysis of exposures to countries and industry sectors, and close interaction with Legal in recovering debts from counterparties in default.

This department will usually report regularly to a Credit Committee of senior managers that is responsible for formal review of new and existing customers, approval of limits and review of limit excesses etc.

### **2.3.4 Legal**

Legal acts as advisors to the bank on all matters including changes in legislation, new business types, activities in new jurisdictions, disputes with counterparties. The department is also responsible for preparation of legal agreements and formal bank documentation, and may also have responsibility for obtaining required customer documentation.

### **2.3.5 Compliance**

Sometimes operates as a joint department with Legal, though its brief is very specific. Compliance is responsible for ensuring that the bank operates in accordance with the rules and regulations stipulated by local regulators. This will necessitate regular reporting, as required, to regulators, continuous monitoring of business activities to ensure that no rules are breached and enforcement of regulatory rules for authorisation of personnel etc.

### **2.3.6 Information Technology**

The huge dependency of banks on technology means that this department is likely to be substantial. In particular, the need for fully automated trading floors, the move to automated trade processing through to final settlement ("straight-through processing") and the increasing complexity of global risk reporting have ensured the criticality of IT in all financial institutions. IT departments will normally comprise management and technicians specialised in the operating environment, including networks and servers, business applications, systems development and IT security.

All organisations are exposed to potential fraudulent or inappropriate use of their computer systems. It will be readily appreciated that banks must particularly vigilant in the areas of IT security and control given the high potential risks of misappropriation and fraud. Most audit departments in banks employ specialist IT auditors to review the controls and security of the IT systems.

### **2.3.7 Taxation**

Most banks will employ tax specialists to provide advice on a range of tax issues arising from the bank's business activities. This will include review of the tax implications of specific transactions and new business, as well as the wider area of corporate tax planning for the organisation as a whole and liaison with tax authorities.

### **2.3.8 New Business**

This function may not, in all cases, be a separate department but rather an ad hoc committee established, as needed, to review all types of new business initiated by the front office. This is an important function comprising representatives from all of the departments above, designed to ensure that, for any new types of transaction being proposed, all relevant regulatory, taxation, accounting, risk and processing issues are fully considered.

## 3. Generic Risk Types

Banks ascribe formally approved limits to all risks which can be quantified and produce regular (at least daily) reports of outstanding exposures against these limits. It is outside the scope of this guide to cover the different methods and bases of calculating the various risk numbers or the process of establishing limits. However, suffice it to say that these areas are all of paramount importance to internal auditors and it is essential that auditors gain a thorough understanding of the concepts involved and the methods and processes employed within their banks to compute these numbers both at a macro and a micro level.

Banks are potentially exposed to the following areas of risk.

### 3.1 Market Risks

These risks reflect the bank's exposure to adverse movements in market rates and prices. The method of calculating this risk will usually be based on the concept of Value at Risk (put simply, this is the potential loss from an adverse movement in rates that the bank might suffer from holding its existing portfolio for a particular period of time). Market risks can broadly be categorised as follows:

- Foreign Exchange Risk
- Interest Rate Risk
- Equity Risks
- Liquidity Risk

Traders manage these risks within their own portfolios throughout the day. However, the bank must also produce a consolidated risk report at least daily to monitor its value at risk. The mechanics of compiling the data for these calculations is onerous and complex and must be prepared independently of the Front Office.

Whilst Value at Risk is an important concept in determining levels of potential risk, it does not show what a worst-case, or long-term, loss would be. As an adjunct to their daily Value at Risk computations, therefore, banks will also perform regular Scenario Analyses (Stress Testing), whereby they assess the potential losses which would arise from extreme moves in the market.

### 3.2 Credit Risks

These risks record the potential loss arising from the bank's counterparties failing to pay amounts due to the bank. In addition to monitoring the risks to individual customers, banks will also analyse their exposures according to country risk to take account of potential political upheavals, and concentration risk to ensure levels of risk to specific industries and sectors are prudent. The following broad categories of risk exist:

- Counterparty Risk
- Country Risk
- Concentration Risk (e.g. by Industry and Sector)

In assessing credit exposures from a trading portfolio, banks will normally show gross exposure for each counterparty and the net exposure. Gross exposure is the sum of all the “in-the-money” transactions with that counterparty (ie transactions where the trade valuation is in favour of the bank). Net exposure is the aggregate of “in the money” and “out of the money” transactions, but should only be viewed as a true exposure if there are legally enforceable netting agreements in place. In addition the value of any collateral provided by the counterparty will be included in the net exposure calculation.

### **3.3 Operational Risks**

This area is currently highly topical given the focus of regulators in attempting to allocate capital requirements based on levels of operational risk. There is no single definition of what constitutes operational risk, encompassing as it does the whole panoply of risks that could arise from a breakdown of the bank’s day-to-day processes and internal controls. Some examples of operational risks would be: trades booked late, failed settlements, unreconciled differences in nostro accounts, valuation price differences, accounting errors; IT security breaches etc. In practice, these areas of risk should be known to management and steps taken to mitigate and control them. However, the increased focus of regulators has necessitated detailed risk self-assessments by financial institutions to ensure all potential operational risks are recognised and ultimately quantified. This is clearly an area where the internal audit department can exercise a significant influence.

### **3.4 Legal and Regulatory Risks**

A bank’s adherence to the laws, rules and regulations of the jurisdictions in which it operates is obviously of paramount importance. Failure to do so, either inadvertently or otherwise, may lead to significant penalties which, in extreme cases, could include suspension of licences. Further, banks must also protect their interests by ensuring that proper due diligence checks are carried out on all potential customers to ensure that they are not only bona fide but have capacity (eg within their articles of association) to enter the transactions. Customer commitments must also be properly documented in legal agreements.

### **3.5 Continuity Planning Risks**

This refers to the ability of the institution to maintain its business in the event of a crisis. At a day-to-day level this might include, for example, the loss of its IT systems due to loss of power or systems crash. At a more extreme level this might include loss of premises due to fire, environmental damage or terrorist attack. Banks should have fully documented and tested disaster recovery plans in place, including offsite office space that can be utilised if needed. In the aftermath of the September 11 events, and the perceived increase in the risk of terrorist attack, this is an area of particular importance.

### **3.6 Image/Reputation Risks**

Confidence in the financial and management soundness of banks is a critical factor in maintaining levels of business. It is this that has, on occasions in the past, caused runs on banks leading to loss of liquidity and, ultimately, failure. Events that harm this reputation can prove highly damaging. This might include adverse publicity resulting from: customer dispute, breach of regulations, improper behaviour of staff, release of inaccurate market information etc.

### **3.7 Fraud Risk**

This potential risk is, in a way, a sub-set of operational risk, though impossible to quantify. There are innumerable potential scenarios, most of which should be mitigated by effective internal controls. However, examples such as a trader creating bogus transactions to inflate his profits; misappropriation of funds via, say, collusion between 2 employees, improper use of confidential data, breach of IT security, payroll fraud etc need to be recognised.

## 4. Critical Control Functions

In addressing the risks highlighted in the previous section, banks must ensure appropriate internal controls are in place. An internal auditor should over time gain a thorough understanding of all of the areas of risk, the necessary controls that should be in place to mitigate them and the nature and quality of the bank's own control structures. It is not possible to provide a detailed listing of all critical controls in this guide, but rather we have highlighted a number of generic standards that should be common to all banks.

### Organisational Controls

- Board level authorities clearly determined;
- Regular reporting to Board of business performance and all key areas of risk;

### Management Controls

- Clear delegation of management responsibilities and authorities;
- Clear delineation between front and back office functions, such that independence of check is not compromised;
- Formal policies and limit structures for all types of business and risk;
- Regular monitoring of risk levels by management;
- New business types are properly reviewed before adoption;
- Fully documented procedures for all day-to-day processes;
- Staffing levels and capabilities are adequate.

### Key Operating Controls

- All job responsibilities clearly defined;
- All transactions properly authorised, documented, booked and settled;
- Payments require dual authorities;
- Clear segregation of duties over confirmation, payment and nostro functions;
- Independent P & L valuation checks in place;
- Regular reconciliation of books and records;
- Client moneys are properly segregated;
- Valuation statements are sent to clients regularly (where applicable);
- IT systems are stable and secure;
- Change management procedures are effective;
- Business continuity plans are in place.

**Regulatory Issues**

- Statutory reports are filed accurately and on time;
- Regulatory limits are complied with;
- Formal client identification and due diligence checks performed on all new customers;

**Further Considerations**

It is important also to recognise that, like any organisation, banks must exercise effective control over standard functions such as fixed assets, personnel and payroll, suspense accounting, physical security etc.



# 5. Roles and Responsibilities of Internal Audit

## 5.1 What does Internal Audit do?

Internal audit is a department, independent of line management, whose prime responsibility is to review the quality and effectiveness of the controls within the banks to manage and mitigate risk and protect the assets of the bank. In performing this work Internal Audit provides recommendations and advice to management on matters requiring attention.

Internal audit will normally produce an annual plan of work to be performed, concentrating on areas of higher risk. Structured timetables and work programmes (e.g. audit programmes) will then be designed for each assignment. At the end of each review, an audit report will normally be prepared for senior management attention and action. Ad hoc assignments may also be performed at the request of senior management where problems or irregularities require further investigation. Further, there are real advantages in ongoing Internal Audit involvement in major projects, including systems developments. In this way audit concerns can be addressed up-front and action taken before the problem becomes too entrenched.

## 5.2 What does Internal Audit not do?

To maintain complete independence, Internal Audit is not responsible for performing or authorising any of the day-to-day tasks which enable the bank to operate. Nor is it directly responsible for the implementation of any new initiatives, even where these arise as a result of audit recommendations. Internal Audit should, however, be prepared to offer advice, cooperation and practical assistance to line management whenever possible.

## 5.3 How should Internal Audit be Organised?

The reporting lines for the Internal Audit Department tend to vary from bank to bank given the disparities in the types of organisation structure. As a general rule, however, the reporting line should be designed to maximise independence whilst permitting the efficient performance of their responsibilities. A reporting line to the Chairman with, say, a dotted line to Chief Executive would be acceptable. A reporting line to Chief Executive with dotted line to Chairman is less advisable but probably workable assuming regular input to the Chairman. An Audit Committee, comprising non-executive directors, should also exist to complete the top-down reporting structure (see below).

Within the Internal Audit department, the management responsibilities may be split either on a regional basis or by business area. In some cases a hybrid, matrix structure may be in place. In practice it is advisable for the Internal Audit organisation structure to mirror the bank's own business structure where possible.

Most Internal Audit departments of banks will also include IT Auditors who will review the controls and security over the operating systems, networks and applications as well as providing audit assistance to systems developments,

## 5.4 What is the Role of the Audit Committee?

The Audit Committee is responsible for reviewing and approving the Internal Audit work plans and for ensuring that appropriate action is taken by management on the audit matters raised. It will also review the resource requirements of internal audit and, at a high level, the quality of work performed. Audit Committees will similarly act as a reporting point for external auditors.

Audit Committees typically comprise around 4 non-executive directors with a requirement for senior executives to attend as required. The Committee would normally meet up to 4 times a year, or as needed.

## 5.5 What skills does the Internal Auditor need?

Internal auditors of banks should have a background that is taken from one of the following areas of expertise;

- Experience in audit work gained either in an external accounting or internal audit environment;
- Experience in banking gained from line responsibilities in a financial institution;
- IT experience gained either in an audit or technical environment;

Increasingly, in more complex businesses, internal audit departments are also seeing the benefit of employing staff with mathematical backgrounds to examine the models used to price and risk manage complex financial products.

## 5.6 How does Internal Audit link with External Audit?

The role of the external auditors is to express an opinion on the financial statements of the bank. They are also, increasingly, required to express opinions to regulators on the quality of critical areas of banks' risk management processes and controls. In both of these areas of responsibility, the external auditor will need to place reliance on the work being performed by internal audit. It is therefore of paramount importance that internal and external audit maintain a regular, constructive dialogue on all aspects of audit planning, coverage and areas of concern, whilst seeking to avoid duplication of effort.

# 6. Regulatory Environment

## 6.1 Overview

The main regulator of financial institutions in the UK is the Financial Services Authority [FSA]. Under the Financial Services and Marketing Act of 2000, the FSA was created as the single regulator for the financial services industry. For a full understanding of the FSA's responsibilities and functions, see their website at [www.fsa.gov.uk](http://www.fsa.gov.uk). The FSA Handbook contains the rules and guidance of the FSA. Every jurisdiction has its own regulatory environment and set of rules. The equivalent regulators in the USA are the Federal Reserve [banking] and Securities and Exchange Commission [securities]. In addition to the FSA rules, the recognised exchanges such as the London Stock Exchange and LIFFE (Financial Futures and Options) have their own rules for members and market participants.

Whilst no auditor can be familiar with the myriad rules and regulations in each country, it is important that banks have legal and compliance specialists who do have this understanding and who would be themselves subject to internal audit.

In addition to individual regulations in each jurisdiction, there has been over the last 20 years an increasing focus on international standards and cooperation amongst the supervisors of the banking system. This requirement has grown from the need to provide a level playing field in which the banks can operate internationally. Major banking scandals and frauds have also highlighted the need for cooperation amongst regulators and common standards within the global markets. Examples such as BCCI, Barings and the recent IPO scandals in the US involving a number of major investment banks emphasise the criticality of global cooperation amongst regulators and consistent international rules to regulate global banks.

In addition the issuance of EC Directives has inevitably led to convergence in many areas of regulation within Europe.

There are too many individual areas of regulation to consider in detail in this paper. However, below are a number of the most high profile areas where international cooperation has been evident.

## 6.2 Money Laundering

The huge increase in money flowing from black market economies, such as drug trafficking, has resulted in ever more elaborate schemes for laundering illicit funds through the banking system. Banks are required by law to closely monitor the source of all significant funds and to take reasonable steps to perform proper client identification checks on all new counterparties. In the UK, the Money Laundering Regulations 1993, coupled with the FSA Money Laundering Rules, provide the legal requirements. Management of banks can now be held personally liable for a failure to take reasonable steps to identify or report a counterparty seeking to process illicit gains.

### **6.3 Capital Adequacy**

In order to prevent banks from taking excessive levels of risk, and thereby maintain stability in the banking system, the Basle Committee, comprising bank supervisors from the G-10 countries, has produced Capital Adequacy Directives (CAD). These have been adopted in the G-10 countries, and ensure that banks maintain minimum capital requirements to reflect their underlying risk assets. The CAD regulations are now receiving further development and refinement through proposals incorporated in CAD II.

### **6.4 Insider Dealing**

Most developed economies have laws and/or exchange-regulated rules which prohibit the trading of securities when in possession of privileged, market-sensitive information. In the UK, this offence is enshrined in the Companies Act 1980 and also in the Stock Exchange Rules. All banks must demonstrate strict adherence to the rules of each jurisdiction in which they operate, including the maintenance of clear Chinese Walls (see below). The Compliance Department is responsible for ensuring that the local laws are fully enforced and adherence is monitored.

### **6.5 Chinese Walls**

Statutes and exchange regulations require all banks to ensure that there is complete separation between trading functions, which buy and sell shares and securities, and investment banking functions which provide advisory and financial restructuring services to companies. These “Chinese Walls” are designed to prevent the transfer of sensitive market information and thereby prevent conflict of interest.

# Glossary

CAD	Capital Adequacy Directives (originally produced by the Basle Committee). Refers to the process adopted by the international banking community of assigning specified levels of capital to risk assets.
Call Option	Contract which provides the buyer with the right, but not the obligation, to buy a specific amount of a given underlying asset at a specified price during a specified period of time.
Chinese Walls	Segregation of responsibilities between investment banking services and traders to prevent access to, and misuse of, market-sensitive information. Convertibles Bonds which entitle the holder to convert to a specified number of shares.
Derivative	A contract which is settled based on the movement in price of an underlying asset, without transfer of the underlying asset.
FRA	Forward Rate Agreement. A contract that specifies an interest rate to be paid on an underlying value at a future date.
FSA	Financial Services Authority. The lead regulator of the UK financial services industry.
Futures	Standardised contracts traded on an exchange which require the delivery of a commodity, bond, currency, stock or index at a specified price on a specified future date
Gilts	Treasury bonds issued by the UK Government
IPO	Initial Public Offering. The first sale of stock by a company to the public.
LIFFE	London International Financial Futures Exchange. The UK exchange for trading futures and options.
Market Maker	An institution which will quote buy and sell prices for a security at any time.
Nostro	Currency account held by one bank at another bank.
Put Option	Contract which provides the buyer with the right, but not the obligation, to sell specific amount of a given underlying asset at a specified price during a specified period of time.
Scenario Analysis	The process of determining the Value at Risk arising from abnormally large market moves over a range of different scenarios.
Spread	The difference between the buy (bid) and sell (offer) prices of a security or currency
Stress Testing	See Scenario Analysis
Swap	Contract to exchange streams of payments over time according to specified terms. Most commonly seen as interest rate swaps.
Value at Risk	Market standard for measuring and reporting financial risks. Defined as "The expected loss from an adverse market movement with a specified probability over a particular period of time"
Warrants	A certificate entitling the holder to purchase a number of securities at a specific price during a specified period of time



## Barclay Simpson

Recruitment Consultants

Barclay Simpson Associates Limited  
Hamilton House  
1 Temple Avenue  
Victoria Embankment  
London EC4Y 0HA

Telephone: 020 7936 2601

Fax: 020 7936 2655

[www.barclaysimpson.com](http://www.barclaysimpson.com)